 ADVISERS

# THE U.S. TRADE DEFICIT: CAUSES, PROSPECTS, AND CONSEQUENCES

## Executive Summary

Current forecasts suggest a 1984 U.S. deficit on merchandise trade of $80-100 billion. This deficit will have two main causes. First, the U.S. has a normal or "structural" trade deficit of perhaps $30 billion, which offsets the persistent U.S. surplus in trade in services. Second, the recent strength of the dollar has reduced the international price and cost competitiveness of U.S. firms, contributing more than $50 billion to the deficit.

The strength of the dollar is largely due to the presence of large budget deficits together with a monetary policy aimed at combatting inflation. Budget deficits, if they are not accompanied by rapid money growth, create a demand for savings, thereby raising interest rates and attracting inflows of foreign capital that bid up the value of our currency. Current inflows of foreign capital may also to some extent reflect world uncertainty and the perception of the U.S. as a "safe haven" for funds, but this is probably a minor factor.

Prospects are poor for any substantial narrowing of the trade deficit for several years. The structural component of the deficit will probably rise gradually over time. The dollar will remain strong until either budget deficits are brought down or monetary policy becomes much more expansionary, and there is little sign of either happening soon.

Given the prospective large budget deficits, the prospect of several years of very large trade deficits is not necessarily a bad thing. The trade deficits are the counterpart of capital inflows which mitigate upward pressure placed by the budget deficit on interest rates. Because interest rates do not rise as much as they would have otherwise, the direct negative consequences of the trade deficit (the part attributable to capital inflow) for exporting and import-competing sectors are offset by indirect positive consequences for interest-sensitive sectors such as construction and capital goods. In the short run the effects on total employment and output in the U.S. economy are small.

Over the longer run, the capital inflows which generate the trade deficit actually help reduce the negative effects of the Federal budget deficit on U.S. growth by allowing part of that deficit to be financed by foreign borrowing rather than reduced domestic investment. By limiting the extent to which investment is crowded out, the capital inflow therefore alleviate the tendency of Federal deficits to reduce the rate of growth of potential output.

The strong dollar, in addition to contributing to the trade deficit, has helped reduce inflation. This is, however, only a temporary benefit, which will have to be given back sometime in the future when the real exchange rate returns to more normal levels.

Finally, although an increase in the trade deficit is actually desirable given the increase in the budget deficit, the increased trade deficit does lead to a substantial reallocation of income and employment among sectors of the U.S. economy. This reallocation poses painful and difficult problems of adjustment and income distribution.

## I. Causes of the Deficit

### A. The Structural Deficit

Over the past decade the U.S. has persistently run a deficit on merchandise trade. Only in two years, 1973 and 1975, did the U.S. run a surplus. As Table I shows, however, since the beginning of floating exchange rates in 1973 the U.S. deficit on merchandise trade has been offset by a surplus on services, so that the overall balance on goods and services has usually been in surplus.

Table 1: U.S. Trade Balances
(billion dollars)

| | Merchandise | Services | Goods and Services |
|---|---|---|---|
| 1974 | -5.5 | +14.6 | +9.1 |
| 1975 | +8.9 | +13.8 | +22.7 |
| 1976 | -9.5 | +18.7 | +9.2 |
| 1977 | -31.1 | +21.2 | -9.9 |
| 1978 | -34.0 | +23.7 | -10.3 |
| 1979 | -27.6 | +32.3 | +4.7 |
| 1980 | -25.5 | +33.0 | +7.5 |
| 1981 | -28.1 | +39.6 | +11.5 |
| 1982 | -36.4 | +39.6 | -3.2 |

In fact, the merchandise deficits should be viewed as natural counterparts of the surpluses on services. U.S. export strength in services (including earnings from investments abroad) tends to support the value of the dollar, leading to a somewhat weaker trade balance elsewhere.

This implies that the U.S. should regard a certain level of trade deficit as normal or "structural," and not as a cause of policy concern. Over the period 1973-1981 the U.S. on average ran a merchandise trade deficit of 0.7 percent of GNP. Using this as a basis would suggest a structural component to the trade deficit of approximately $25 billion for 1984. However, there has probably been some upward trend in the structural deficit, so the right number should be larger, perhaps more than $30 billion.

B. Effects of the Strong Dollar

From its low point in 1980 to May 1983 the dollar rose 40 percent against the German mark, 20 percent against the Japanese yen, and it has appreciated by substantial amounts against all other major currencies as well. The Federal Reserve's index of the dollar's average exchange rate against other currencies was 43 percent higher in May 1983 than in June 1980. On a "real" or inflation adjusted basis (measuring inflation by consumer prices) the dollar has risen some 40 percent since its low point.

It is true that the dollar was unusually weak in the late 1970s. Thus it may be appropriate to use a longer period as a basis for comparison. This still, however, suggests an unusually strong dollar. The real exchange rate of the dollar in May was approximately 25 perccent above its average value from 1973 to 1981.

Past experience indicates that the effects of the exchange rate on trade take some time to be fully felt, perhaps two years. By 1984, however, most of the effects of the strong dollar on trade should be visible. Econometric estimates suggest that each 10 percent appreciation of the dollar, other things equal, eventually worsens the trade balance by more than $20 billion. Thus, the recent strength of the dollar would by itself tend to cause the deficit to widen by more than $50 billion.

C. Relative Cyclical Position

Recessions in the U.S. are usually associated with improvements in the U.S. trade balance, while recoveries are associated with deteriorating trade balances. The reason is that demand for imports rises or falls with the general level of demand. In fact, demand for merchandise imports tends to be much more cyclically sensitive than overall demand, for two reasons. First, demand for merchandise in general fluctuates more than demand for services over the business cycle. Second, in some sectors domestic capacity is used first, while imports act as a residual supply, so that imports fluctuate more than total demand. As a result, the share of imports in GNP normally falls during recessions and rises in recoveries.

It is also true, of course, that recessions abroad tend to reduce U.S. exports and that recoveries abroad trend to increase them. In 1982, however, the U.S. was in a deeper slump than other industrial countries, so that the net effect

of cyclical factors was to reduce the size of the trade deficit. As the U.S. economy recovers, all indications are that the pace of recovery here will be more rapid than that abroad, so that the cyclical factors will begin to move the other way. By 1984 cyclical factors may be having a net negative impact on the U.S. trade balance.

D. Other Factors

There are two other smaller factors affecting the U.S. trade deficit, one negative and one positive. Together these factors probably roughly cancel out.

The negative factor is the effect of global debt problems on U.S. exports. U.S. exports to high-debt countries, especially Mexico, have fallen off sharply as these countries have been forced to tighten their belts in the fact of a severe liquidity squeeze. While the import contractions have been dramatic for the countries involved, however, problem debtors account for less than one-sixth of U.S. exports; the overall effect on the U.S. trade balance is probably less than $10 billion.

The positive factor is the decline in oil prices, which has reduced the U.S. oil import bill by approximately $11 billion. While there will be some partially offsetting reductions in U.S. exports to OPEC, these will be small. Thus, the oil price reduction will roughly offset the impact of debt problems.

E. Summary

If, as is almost certain, the U.S. experiences a record trade deficit next year, there will be two main causes. A substantial part of the deficit will be "structural," a normal counterpart to the U.S. export surplus in services. Most of the remainder of the deficit will reflect the effects of the unusually strong dollar on U.S. competitiveness.

## II. Causes of the Strong Dollar

### A. High Interest Rates

The most important factor in the strength of the dollar is the role of high U.S. real interest rates in attracting capital inflows. Though U.S. inflation performance has improved relative to other countries, the interest differentials between the U.S. and others have not narrowed to the same extent. As a result, the U.S. has become an attractive place for foreign investors to put their money. Table 2 shows some illustrative numbers. In 1980, when the dollar was weak, U.S. short-term interest rates were much higher than those in Germany or Japan; but U.S. inflation was also much higher, so that if anything U.S. real interest rates were lower. By mid-1983 the interest differentials had narrowed somewhat, but dramatic U.S. progress against inflation left U.S. real rates substantially higher than those abroad. Furthermore, there currently is widespread concern that real rates will rise further in the future. Both the currently high level of real rates in the U.S. and the possibility of further increases are acting to keep the dollar high.

Table 2: Interest Differentials and Inflation Differentials

| | 1980 | |
|---|---|---|
| | U.S. vs. Germany | U.S. vs. Japan |
| Difference in 3-month Eurocurrency Rate | 5.5 | 2.9 |
| Difference in Consumer Price Inflation | 5.8 | 4.6 |

| | 1983, 2nd Quarter | |
|---|---|---|
| | U.S. vs. Germany | U.S. vs. Japan |
| Difference in 3-month Eurocurrency Rate | 4.2 | 3.1 |
| Difference in Consumer Price Inflation | 0 | 1 |

* Estimated

Why are U.S. short-term real interest rates so high? During 1981 and the first half of 1982 it was reasonable to explain high real interest rates as a transitional problem reflecting disinflationary monetary policy. When the rate of growth of nominal GNP is slowed after years of inflation have caused inflationary expectations to become deeply embedded in the economy, the rate of price increase does not fall easily. Instead, prices continue to rise for a time, producing a liquidity squeeze which temporarily raises real interest rates. Such a liquidity squeeze may account for the high interest rates and also the strength of the dollar in 1981.

Since the summer of 1982, however, monetary policy has been loosened considerably. Money growth has accelerated, while inflation has fallen. Yet real interest rates have remained high and probably even risen on long-term bonds.

The main explanation of the persistently high level of real interest rates lies in the Federal budget deficit, together with a monetary policy aimed at combatting inflation. To illustrate, from 1974-81 net saving averaged less than 7 percent of GNP. Unless the government's financing needs are offset by a compensating increase in private sector savings -- something of which there is so far no sign -- they must be filled by a combination of reduced investment and foreign capital inflow. The channel through which both these forms of adjustment take place is through high real interest rates, which both discourage investment and attract foreign capital. The foreign capital inflow is reflected in a strong dollar which produces a widened trade deficit. In fact, net capital inflow into the U.S. is by definition equal to the deficit in the U.S. balance of payments on current account (a measure which combines the balances on goods and services together with some other minor items).

It is true that other countries also have large budget deficits. But the U.S. deficit is much larger relative to private sector savings because of our low savings rate. And the trend has been different. The U.S. started from near-balance several years ago, and has moved sharply into

deficit. Other industrial countries, by contrast, have moved toward tighter fiscal policies.

Current projections suggest that the U.S. budget deficit for fiscal 1984 will be about $200 billion, while the negative contribution of the exchange rate to the trade balance will be about $50 billion. If all of the strength of the exchange rate is attributed to the budget deficit, this would imply that inflows of foreign capital were financing one-quarter of the deficit. Given the increasing integration of world capital markets this does not seem to be an unreasonable number.

B. The U.S. as a "Safe Haven"

Although the effects of the Federal deficit in driving up real interest rates and attracting foreign capital could plausibly account for all of the dollar's strength, it has also been suggested that there are other reasons for capital inflow into the U.S. The main other cause which has been suggested is that economic and political uncertainty has increased, and that the U.S. is viewed as a "safe haven" for investment.

It is difficult to put much weight on this argument. While there have been serious economic and political problems in some countries, it is hard to see that there is much risk to financial capital in Canada, the U.K., Germanmy or Japan. There may be some investors who do regard other industrial countries as unsafe. For the same reasons that government intervention in exchange markets is usually ineffective, however, the actions of any minority group of investors can have only a small effect on the exchange rate.

Suppose, for example, that capital flight from Latin America tends to go to the U.S. This will initially tend to raise the value of the dollar. The higher price of U.S. assets, however, will cause other investors to move to other industrial countries such as Germany or Japan. Thus a decision by Latin Americans to move capital into the U.S. would generate partly offsetting capital outflows from the U.S. to other countries. The net capital inflow would be only a fraction of the initial capital movement, and the effect on the exchange rate would be small.

In order to argue that "safe haven" considerations play a major role in explaining the dollar's strength, it would be necessary to argue that a large fraction of the world's investors regard the U.S. as a significantly safer place to hold assets than other advanced countries. This does not appear to be the case.

C. Policies of Other Countries

There have been persistent accusations from the business community that the strength of the dollar reflects deliberate undervaluation of currencies by other countries, particularly Japan. The yen issue was reviewed by the CCEA last year, and this view was rejected. The CCEA study, prepared by the Treasury Department and the Council of Economic Advisers, concluded that:

- Japanese policy has not sought to weaken the yen. Such capital controls as Japan retains tend to limit capital

outflow and thus strengthen the yen. Japan's intervention in the foreign exchange markets in recent years has attempted to sustain the yen's value -- albeit with little success.

- The yen does not appear to be out of line with currencies other than the dollar. From 1973 to 1980 Japan's average balance on trade in goods and services was only slightly in surplus. The yen is currently weak in real terms against the dollar compared with its average over that period, but less so than other major currencies such as the German mark and the French franc. In other words, the yen has actually risen against the mark and franc.

New evidence since the CCEA yen study was prepared has provided no reason to alter these conclusions. It remains the case that the explanation of the strength of the dollar must be sought in U.S. policies rather than in the policies of other countries.

## III. The Outlook for the Deficit

### A. The Structural Deficit

The structural deficit in merchandise trade can be expected to change only slowly, as the underlying structure of the U.S. economy changes. And the most likely direction of change is upward. The U.S. has become an increasingly large net exporter of services, both in absolute terms and relative to GNP, over the past twenty years, and there is every reason to expect the trend to continue.

B. The Exchange Rate

Since the budget deficit is probably the major cause of the strong dollar, the dollar will only weaken significantly when that deficit begins to come under control. At this point there seems to be very little political willingness on the part of Congress to enact either spending cuts or tax increases sufficient to significantly close the fiscal gap. As long as that remains the case, whatever role budget deficits play in keeping both interest rates and the dollar high will continue. At the moment, the trend in interest rates is clearly upward.

To the extent that the strength of the dollar also reflects global uncertainty and the perception that the U.S. is a safer place for investment than other countries, worldwide economic recovery may tend to weaken the dollar slightly. As the world economy grows the payments position of high-debt LDCs should ease, increasing confidence in the world financial system. At the same time, if other industrial countries succeed in growing rapidly enough to reduce their unemployment, some of the political uncertainties which have worried international investors could fade. Since the U.S. is apparently where nervous investors prefer to keep their money, a stabilization of the world scene could have the effect of reducing capital flows into the U.S.

The chain of connections through which the world recovery could weaken the dollar is, however, a long and uncertain one. Most estimates suggest that the major sources of international

economic uncertainty -- debt problems, and high unemployment in Europe -- will persist at least for several years. Given this prospect, and given also the probable dominant role of the budget deficit, it is a strong possibility that the dollar will remain unusually strong through the mid-1980s.

Even if the dollar does weaken, it will take time before this has a dramatic effect on the trade balance. As mentioned above, past experience suggests that exchange rate changes take 2 years before having their full effect on trade. Even if the dollar were to return to its average level of 1973-81 during the next few months, the trade deficit in 1984 might still exceed $80 billion.

C. Cyclical Factors

In the long run the recovery in other advanced countries can be expected to catch up with that in the U.S. As the U.S. economy approaches full capacity, its growth will have to slow down. At the same time, slack capacity in the rest of the industrial world will allow room for rapid growth, and eventually this slack will be taken up.

The question is when this will happen. There is still enough excess capacity in the U.S. economy to allow several years of growth at 4-5 percent. Meanwhile, there are few signs suggesting that growth in other industrial countries, particularly in Europe, will rise much above 2 percent in the near term. Expansionary policy in much of the industrial world has been hamstrung by a variety of constraints. On the one

hand, most countries are unwilling to use expansionary fiscal policies because they are concerned about the size of their budget deficits. On the other hand, they are also reluctant to loosen monetary policy, partly because of concern about inflation, partly because they are unwilling to weaken their currencies still further against the dollar.

The recovery in the U.S. will by itself tend to promote expansion in other countries, as increased U.S. imports exert a multiplier effect on the rest of the world. Most estimates suggest, however, that this effect is modest. A typical estimate is that it takes 5 percent percentage points of U.S. growth to produce an additional percentage point of growth in the rest of the OECD.

Based on these factors, the change in the relative cyclical position of the U.S. is likely to contribute to a widening trade deficit at least through the end of 1984, and this effect may continue to be a net negative factor for two or three years thereafter.

D. Summary

The 1984 trade deficit will almost certainly be larger than the 1983 deficit, due to the U.S. recovery and some residual effects of the strong dollar. There are only weak reasons for expecting improvement thereafter. The dollar may weaken somewhat and recovery in the rest of the industrial world may eventually contribute to an increased demand for U.S. exports. But many of the major factors contributing to a large U.S. trade deficit seem likely to persist.

## IV. Implications of the Deficit

### A. Short Run Output and Employment Effects

In a direct sense the deficit acts to depress demand, and thus output and employment in the short run. Both lost exports and increased imports represent demand switched from U.S. to foreign goods.

Given the current stance of monetary and fiscal policy, however, capital inflows produce indirect positive effects on demand which offset the negative direct trade effects. Increases in capital inflows, by limiting the rise in interest rates, reduce the pressure on domestic spending, especially investment. The result is a change in the composition of demand and employment rather than a change in its overall level.

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The crucial point is that U.S. monetary policy involves targeting of monetary aggregates which normally bear a stable relationship to nominal GNP. Furthermore, to the extent that these relationships shift, the Federal Reserve has attempted to offset the shifts with changes in policy.

When capital inflows increase, the effect is to reduce the demand for the monetary aggregates. This leads to a smaller rise in interest rates than would otherwise have occurred, which in turn means less crowding out of investment. The best working hypothesis is that the favorable impact on investment nearly matches the increase in the trade deficit, so that the net effect on the demand for domestic output is small. The short run effects on total output and employment

are therefore also small. Note, however, that output and employment will be reallocated -- the trade deficit leads to lower output in exporting and import competing sectors with higher output in construction, capital goods, and consumer durables, than would otherwise have been the case.

In the current context the budget deficit has been placing upward pressure on interest rates. Thus the rising capital inflows have been limiting the increase in interest rates rather than actually depressing them. The point remains, however, that the trade deficit is probably not acting to depress output to any great extent.

B. Longer Run Growth

Fluctuations in demand determine the short run growth rate of the economy. Over the longer run, however, growth depends on expansion in potential supply. A key factor in this supply growth is investment. The capital inflows which generate the trade deficit help limit the extent to which budget deficits crowd out domestic investment, and thereby mitigate the negative impact of budget deficits on investment and growth.

The essential point is that the trade deficit is the counterpart of capital inflows into the United States. These capital inflows add to the supply of savings available for investment, and are reflected in interest rates which are lower than they would have been with a smaller capital inflow. The result is higher domestic investment. In the current context,

again, the trade deficit acts to limit the crowding out of investment by the budget deficit rather than to have a positive impact.

While the capital inflows which produce the trade deficit help sustain investment, they do have a negative effect on future U.S. national income through another channel. The larger the inflow, the lower will be future U.S. net claims on the rest of the world, and thus the lower our income from overseas investments and the higher our payments of interest and dividends to foreigners. There are two reasons, however, why these negative effects are likely to be outweighed by the positive effects of sustaining domestic investment. First, because of taxes the rate of return on investment is a good deal higher than the real rate of interest even in normal times, so that additional capital inflows increase U.S. output by more than the additional interest payments to foreigners. Second, the situation in the next few years, with investment depressed by the government's need for credit, will be one in which the remaining investment yields unusually high rates of return. In effect the trade deficit will serve as a "safety valve" for the budget deficit, helping to reduce undesirable pressure on investment.

The argument that the capital-inflow-generated trade deficit helps sustain long run growth may seem surprising, but it should not be. When developing countries with high demands for capital attract foreign investment (and are able to run

trade deficits as a consequence) this is generally regarded as contributing to their growth. The surge in the budget deficit has temporarily turned the U.S. into a country with a high demand for capital, which is desirable to meet partly through capital inflows -- which lead to an enlarged trade deficit.

C. Inflation

The rise in the foreign exchange value of the dollar has contributed to the recent fall in the inflation rate. This is, however, only a temporary gain.

When the dollar rises against foreign currencies, U.S. import prices fall, representing a direct negative effect on the consumer price index. There are also indirect effects. First, U.S. firms selling internationally traded goods tend to reduce their prices to meet foreign competition. Second, lower prices tend to lead to lower wage settlements, leading to further reductions in prices, and so forth. The Federal Reserve estimates that, taking into account both direct and indirect effects, a 10 percent appreciation of the dollar lowers consumer prices by about 1.5 percent. This means that the rise of the dollar since its low point in mid-1980 has left consumer prices about 6 percent lower than they would otherwise have been. The dollar was unusually low in 1980, but the rise of the dollar relative to its 1973-81 average still has lowered consumer prices by almost 4 percent.

This gain will, however, be transitory. In the long run the U.S. cannot continue to import capital, so the real exchange rate will have to return to a more normal level. Furthermore, during the interim the accumulated capital inflow will mean that U.S. net income from investments abroad will fall, so that the service balance will be less favorable than it would otherwise have been. This will have to be offset by an improved trade balance, requiring that the real exchange rate eventually depreciates by more than its initial rise. This depreciation will be reflected in higher inflation.

The gains against inflation resulting from the strong dollar, then, do not represent permanent progress but rather loans from the future. The borrowed reductions in inflation will eventually have to be repaid with interest.

D. Sectoral Impacts

The politically most important effect of the trade deficit is its impact in reallocating income and employment among sectors. The key problem, as already noted, is that sectors which are hurt tend to perceive their problems as directly related to trade, while the beneficiaries are helped indirectly and may not perceive the relationship between their welfare and foreign trade.

The impact of trade on particular sectors is dealt with in another section of this report.